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Whether a company is a publicly held corporation is to be determined based on the facts as of the last day of the tax year. Consequently, a company that goes private during the year is not subject to Section 162(m) for that year. For the reverse situation, a company that goes public, the proposed rules state that Section 162(m) will not apply to compensation paid under plans or arrangements in existence when a corporation becomes a publicly held corporation, provided that those plans or arrangements are adequately disclosed as part of the public offering.

Covered Employee

Under the proposed regulations, covered employees are measured on the last day of the tax year, and include the chief executive officer and any other individuals whose compensation is required to be reported to shareholders under the 1934 SEC Act as the four highest-paid officers. The last day of the tax year is the critical time, so that employees who may appear on the summary compensation table in SEC disclosures, but who are no longer employees as of the end of the year, would not be included.

Performance-Based Compensation

The rule for performance-based compensation (which is not subject to the \$1 million cap) is extremely important. For this exception to apply, four conditions under Section 162(m)(4)(C) must be met:

1. The compensation must be payable because of attaining performance goals.
2. The goals must be established by a compensation committee of the board comprised solely of two or more outside directors.
3. The material terms of the compensation and

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Prop. Regs. Issued on Deduction Limits for Executive Compensation

by Robert W. Wood • San Francisco

Proposed regulations have been issued under Section 162(m), added by the Revenue Reconciliation Act of 1993 generally to deny a deduction to any publicly held corporation for non-performance-based compensation paid to a "covered employee" in excess of \$1 million per year. The preamble notes the need to provide some basic guidance on the new deduction limit, and the proposed regulations expressly *do not* purport to be comprehensive.

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the performance goals must be disclosed to and approved by shareholders before payment.

4. The compensation committee must certify that the performance goals have been satisfied before payment.

The proposed regulations state that compensation must be paid under one or more pre-established performance goals. While any business criteria may be used for performance goals, a goal will not be considered pre-established unless it has been established in writing by the compensation committee before the employee performs the relevant services, and while the outcome under the goal is substantially uncertain. Thus, for a bonus to be paid based on an increase in sales during 1995 to be considered performance-based, the performance goal would have to be established before 1995.

Both the performance goal and the amount of the compensation must be "objective." This test examines whether a third party having knowledge of the relevant facts would be able to determine whether and to what extent the goal was satisfied and the amount of the compensation that would be payable. Despite the objectivity standard, the proposed regulations provide that the compensation committee may retain the discretion to reduce the amount of compensation or other economic benefit otherwise payable if the performance goal is attained. Thus, the proposed regulations allow the board's compensation committee the flexibility to reduce an award without violating the requirement that performance goals be fixed and the amount of compensation be nondiscretionary.

Other Rules; Effective Date

The proposed regulations also attempt to apply the performance goal standards for stock option and stock appreciation rights arrangements. Outside director requirements for the compensation committee are also covered in the proposed rules.

The general effective date for the proposed regulations is 1/1/94. Thus, the rules are proposed to be effective for payments that would be deductible for tax years beginning after 1993. Transition rules are discussed below.

Transitional Relief

Shortly after the release of the proposed regulations in late December 1993, the Service issued Notice 94-2, providing attractive transitional relief from Section 162(m). After the issuance of the proposed regulations, comments suggested that companies could desire to base their performance goals on services and performance results for the entire 1994 calendar year. Such companies could well have had problems arranging for their compensation committees to set performance goals before 1994.

Consequently, Notice 94-2 states that if a compensation committee establishes a performance goal before 4/1/94, the IRS will treat the goal as having been established before the commencement of the services to which the goal relates, even though the normal rule is that the performance goal must be set before the commencement of the year. Thus, companies will have until that date to ensure that their compensation committee sets performance goals for 1994.

In addition, at the time the compensation committee actually establishes the goal, the outcome of the goal must be substantially uncertain, and the period of services to which the goal relates must not begin before 1994, and must be scheduled to continue for at least nine months. ■

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